FESE Input

PRIIPs Regulation – Impact on retail investors' access to corporate bonds

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With MiFID II/MiFIR, PRIIPs Regulation, and the new EU Prospectus Regulation[1], legislators intended to strengthen the regulatory framework in order to increase transparency, better protect investors, and rebuild their confidence in financial markets following the financial crisis in 2008.

Fostering retail investors' participation in capital markets is a key objective of EU Capital Markets Union (CMU); however, in some instances, various provisions included in the above regulations have created unintended consequences. This is the case, for example, of corporate bonds markets where the requirements have become so onerous, it has become a lot less attractive to make corporate bonds available to retail. This, ultimately, means retail investors can no longer access a lot of these instruments.

Classic corporate bonds are interest-bearing securities that are issued as debt capital. They usually serve the goal of long-term financing, for example, of innovative projects and new manufacturing capacities. A bond gives creditors the right to be repaid of the capital they provided at the end of the maturity period along with the interest agreed upon[2]. They are therefore relatively easy for investors to comprehend. Compared to equities, corporate bonds issued by the same issuer are considered a less risky form of investment. Bonds are issued publicly by issuers to investors on the primary market and thereafter they can be traded on the secondary market.

1. A KID for each PRIIP?

In line with the provisions included in the PRIIPs Regulation, manufacturers of packaged retail investment products (PRIIPs) are responsible for drawing-up for those products a key information document (KID) and for publishing it on their website. A person advising on or selling a PRIIP must provide retail investors with a KID prior to selling it. KIDs are intended to explain the basic characteristics and risks of PRIIPs in simple and straightforward terms.

To better explain the effects of these provisions, valid across the EU, let's use the example of Germany, where 50% of corporate bonds are classified as PRIIPs:

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[1] Markets in Financial Instruments Directive II (MiFID II)/Markets in Financial Instruments Regulation (MiFIR) in force since 03.01.2018; Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs Regulation) since 01.01.2018; Prospectus Regulation – with few exceptions – since 21.07.2019.

[2] Additional rights can also be defined. For example, a plain vanilla bond grants the creditor fixed interest over the bond period. By contrast, in a variable interest over the bond period. By contrast, in a variable interest bond (floater), the interest rate over the bond period tracks a reference interest rate such as EURIBOR.

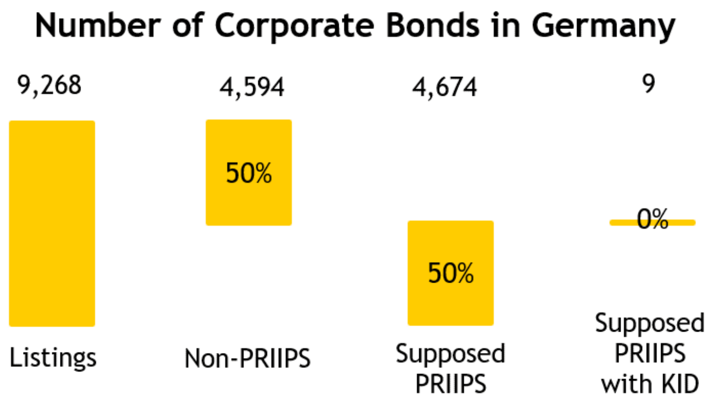

Figure 1: Limited Tradability of Corporate Bonds for Retail Investors (Source: FESE members own statistics)

In our view, this high percentage is questionable since even simple corporate bonds with make-whole call provisions are classified as PRIIPs. Also, it should be noted that if an issuer does not classify a bond as PRIIP or non-PRIIP, then it is the distributor who needs to make the decision, which could be ambiguous.

2. MiFID II target markets: Only professional and eligible counterparties

Furthermore, new requirements under the heading 'MiFID II Product Governance' have expanded obligations for issuers and persons advising on or selling a PRIIP. These include the product approval process and the determination, by the issuer, of the target market for each product. The person advising on or selling a PRIIP evaluates the issuer's determination of the target market against its own customer group's requirements and considers the target market during each sale. To this end, it compares target market data with its customers' profiles and in certain cases corporate bonds that are not PRIIPs have a target market other than retail investors.

3. How to address the decrease in product diversity for retail investors?

The increased regulatory requirements have resulted in decreasing the opportunity for retail investors to invest directly in corporate bonds. This is diametrically opposed to the EU's objective of creating a CMU[3]. Rather than barriers to investments being dismantled, new ones are being created. Thus, the new rules hinder retail investors from planning independently for retirement by including corporate bonds in their portfolio in light of increasing life expectancy and demographic changes. Retail investors' savings are hence not being mobilised to finance the economy.

In its characterisation of the situation, the joint committee of the European Supervisory Authorities (ESAs) confirmed FESE members' assessment. In practice, even simple classes of bonds with make-whole call provisions are often classified as PRIIPs[4]. The available range is further restricted by the MiFID II target market definition. Furthermore, since the new rules entered into force, trading volumes in corporate bonds have declined significantly with an impact on the overall market liquidity.

[3] Action plan for creating a Capital Markets Union by the EU Commission from 30.09.2015.
[4] Letter of the joint committee of the ESAs to the European Commission from 19.07.2018.

FESE would like to call for a united effort by legislators and regulators at both European and national levels to acknowledge the burdensome situation built up around PRIIPs Regulation and act in order to enable direct investments by retail investors in bonds once again.

An important first step, albeit an insufficient one, is to clarify that bonds with a make-whole call provision do not qualify as PRIIPs.

About FESE

The Federation of European Securities Exchanges (FESE) represents 36 exchanges in equities, bonds, derivatives and commodities through 19 Full Members from 30 countries, as well as 1 Affiliate Member and 1 Observer Member.

At the end of August 2019, FESE members had 8,853 companies listed on their markets, of which 13% are foreign companies contributing towards the European integration and providing broad and liquid access to Europe's capital markets. Many of our members also organise specialised markets that allow small and medium sized companies across Europe to access the capital markets; 1,340 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers. Through their RM and MTF operations, FESE members are keen to support the European Commission's objective of creating a Capital Markets Union.